



Idiots

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T&B – The “Idiots” Issue

The Moron is deadlier than the Neutron

Allen Ginsberg

To JH – whose profound and self-satisfied cluelessness has served to greatly enlighten as to the inner workings of the mind of the consensus...

and to M. – who reminded me that there is light at the end of every tunnel...

The idea for the present issue came to T&B very early one morning while passing through Singapore for client meetings on our way home to Moscow, following a delightful (if unseasonably rough) crossing of the Indian Ocean aboard El Aleph.

Tuning in to the 24-hour electronic wallpaper, we were subjected to an unusually irritating television advert for one of the big oil companies. You know the sort: a voice-over dripping with reassuring and benevolent authority, telling us how deeply the company cares for our environment. How – each day – they were working hard to save the planet. Meanwhile, the camera pans to reveal as racially diverse a group of company scientists as Central Casting could assemble, including at least one handicapped, lesbian dolphin of African descent, toiling hard to make the world a better place for our children.

This begs the question: do they think us complete idiots? The oil companies are doing precisely what they are programmed to do in the capitalist system¹: maximizing profits by whatever means – fair or foul (discounting the latter for the probability of judicial sanctions) – and to hell with the externalities. They would happily burn our planet to a light grey crisp in order to beat their quarterly revenues targets – and you, dear reader, know it... and they know you know it. So why all the posturing? Must they treat us like morons?

Except at the margins, the response of the oil companies to climate change sciences has involved not any serious increase in their commitment to alternative energies but instead a fairly successful attempt to discredit climate science in the public eye – analogous to the arrière-garde efforts of the tobacco companies to convince us that there was some legitimate doubt as to whether cigarettes caused cancer. Obviously, any evidence-based approach was going to come up unfavourable, so instead, they ploughed their massive PR budgets into creating the illusion that there was some legitimate scientific doubt; after all, if even the scientists could not make up their minds, then one might as well just keep puffing away!

As regards climate change, rather than attempting to counter the science with science, they have focused in on a series of e-mails suggesting that one particular group of British scientists was fallible – with a tendency to disparage their opponents and to show bias. This, of course, does nothing to impeach the conclusions of literally tens of thousands of scientists working around the globe, but, yes, it did reveal that – shock-horror – scientists too are human, have egos, and bear grudges.

In short, people will reliably find whatever excuse possible to disbelieve inconvenient truths, and the oil companies have succeeded quite nicely in providing the needed excuses. As for the ultimate reward for all their hard work, as Warren Buffet put it: “Don’t these people have grandchildren?”

The present rant was never intended as a broadside against the oil companies – much less as another tiresome anti-capitalist screed. The pharmaceutical manufacturers are even worse, elevating sanctimonious hypocrisy literally to a fine art form – with dire consequences for public health. The military-industrial complex of which Dwight Eisenhower so presciently warned has succeeded in hijacking US governance. The tobacco industry is working hard to poison the women and children of South-East Asia as their Western markets shrivel. The mainstream press succeeds each day in elevating political prostitution to new summits, debasing the political discourse in selected countries into a grotesque parody of Democracy. We could go on and on...

*The point is not that any of the above-mentioned is inherently evil – it is simply that their DNA is programmed for profit maximization, and for this only; to expect them to act against their own near-term economic interests is simply foolish. The Anglo-Saxon capitalist system – like their courts – is an adversarial system in which the economic actors are expected to seek to maximize their own benefit. For the system to work for society at large, **a strong regulatory framework is a vital counterweight**. In the absence of a balancing factor, the corporate state achieves a dictatorship no less fearsome than that of the classical military regime. Against this, the regulatory agencies must seek to advance the commonweal, with the ability to mete out sufficiently dissuasive punishment for anti-social behaviour, while adjusting the incentives to encourage activity beneficial to the broader society. If the regulator fails, the whole system fails. In the US and much of the West, it is now failing...*

The sickest aspect of the Neo-liberal ideologies: Libertarians, Ayn Rand, etc. is that they were scientifically designed to benefit the “haves” at the expense of the “have-nots” – while counting on the latter to be sufficiently obtuse, confused, and misinformed to buy in. The Tea Party demonstrates how successful this undertaking can be in the absence of a functioning education system and a press reasonably free of the control of powerful financial interests. The ability of those who have benefitted hugely from the current economic system to convince themselves that its untrammelled function is of universal benefit to mankind, not just to their own social class, never ceases to fill us with admiration.

¹ Note: throughout this opus, we will refer to Capitalism NOT as opposed to Socialism – or any utopian blueprint for the organization of the economy and society (Russia’s experience was not particularly encouraging in that respect) – but simply as a descriptive term for the context in which certain entities and institutions evolve. The term is intended as value-neutral.

As companies reach a certain size, they can thrive only by modifying their environments; at some point, revenues can be meaningfully increased only by expanding their influence over wide swaths of public policy. In order for the drug companies to continue to grow their earnings, public attempts to control burgeoning medical costs must be frustrated. Eisenhower's Military-Industrial complex thrives thanks to fear and ideology – resulting in an increasing share of a limited national wealth being spent upon warfare. Beyond a certain size, technology companies will buy or crush competitors to enforce monopolies. Banks succeeded in dismantling Depression-era safeguards (US) or proper prudential regulation (EU/UK) just before spiralling towards bankruptcy, necessitating public bailouts of historic proportions.

Late-stage capitalism will reliably see the growth of corporate entities to a size where they can overshadow individual countries. Rather than setting arbitrary limits on corporate size, what is necessary is a countervailing force sufficiently robust to curb the excesses while allowing the benefits. We will here disappoint our few readers (Joanna, this is for you....) still defining themselves as “socialists” by stating our belief that some form of liberal Capitalism is the best economic system yet devised **for the developed, industrialized economies** – i.e. the rich countries. That said, if not counterbalanced by an equally strong public sector, the tyranny of the Corporation will be no less cruel and destructive than that of your middling average dictator.

And now, having blown off a bit of steam, we shall proceed to examine a field rich for the harvesting – human idiocy, along with some targeted reflections on how it works in practice, and ultimately, considering our ultimate goal – how to make money on it, while awaiting the apocalypse!

Global Politico-Economic Drivers – The Dirty Dozen

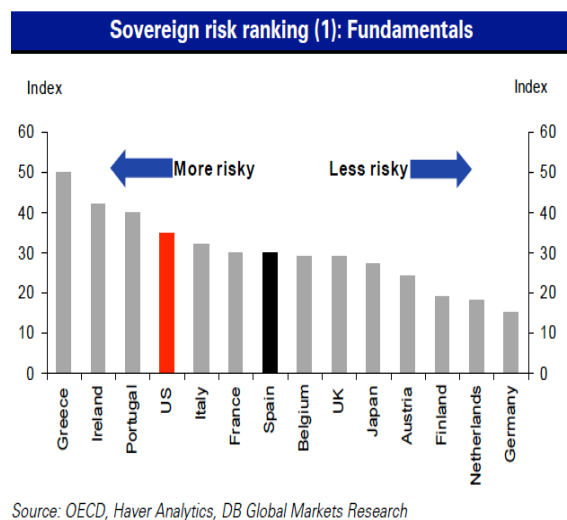
1. Another Day in the Death of the Dollar

T&B has never been a great fan of the rating agencies – while agency ratings can be quite useful for inter-group comparisons between companies issuing debt in the same market, they tend to be comically misguided as regards sovereign ratings. The sovereign CDS market – i.e. the traded assessment of default risk – increasingly discounts the views of the agencies.

The gradual erosion of the predominance of the US dollar is a function of the secular decline of US politico-economic predominance. The recent S&P downgrade on the outlook for the US sovereign credit rating showed some unusual political courage by a rating agency badly discredited by its role in the US credit crisis, and whose sovereign ratings (unlike their more useful corporate ratings) are almost universally viewed as lagging indicators.

The threat of a downgrade simply confirms what everyone already recognized – the lack of any real political will to endure the deeply unpopular cuts in expenditures and tax hikes

necessary to restore solvency. In our view, based upon the debt numbers alone, the US ceased to be a AAA borrower several years ago – a recent paper by Deutsche Bank showed that its debt sustainability parameters were closer to those of the European periphery than the class of senior sovereign borrowers.



Indeed, by this logic not only is the United States no longer a AAA borrower, but it is investment grade only because of its ability to issue debt in its own currency – stripped of that privilege, it would be clearly sub-investment grade based solely upon debt sustainability numbers. That is, of course, neither here nor there – the US is not going to be forced to refinance its maturing debt by borrowing Euros, Yen or Yuan, at least for the next five years – i.e. the current default risk is precisely nil.

Since the US can always print enough dollars to pay its maturing obligations, and if markets will not buy its new bonds at a suitably low rate of interest, then the Central Bank will almost certainly oblige – it is the currency that will take the strain. Markets are already discounting this, with the dollar plunging against competing currencies, real assets, and especially gold.

Given that the US political system is not sufficiently robust to take the pain of a prolonged and deep recession caused by severe fiscal drag, that the democratic deficit precludes the necessary redistribution of the huge economic effort required to pay down the debt while maintaining the level of social services expected of a modern state, along with a generalized refusal to recognize that the hypertrophic military has become an unaffordable luxury, the only conceivable outcome would appear to be the debasement of the currency.

While calls for an imminent end to the dollar standard have proved somewhat premature, the process has been underway for a decade at least; thanks to “Quantitative Easing”, it is accelerating, especially in Asia, where despite near-zero interest rates, the volume of Renminbi (Chinese) deposits is literally exploding. Singapore has set out to rival Hong Kong for Renminbi-based clearing, with retail diversification of currency portfolios almost universal – the FT reports that Hong Kong banks are now forced to fund themselves in the wholesale market, given the absence of demand for dollar assets.

The US dollar has been in a secular downtrend since the beginning of the millennium, interrupted only by the huge dislocation of the 2008 credit crisis, which caused European banks to scramble desperately to raise dollars to cover their huge losses on US subprime. We would note that during the most recent bout of

global volatility (early 2011) not only did the USD not benefit from flight-to-quality, it actually weakened. No doubt that there will be periodic bouts of dollar-strength and **trading it will require fast reflexes**, however our strongest conviction call (along with the secular increase in commodity prices) is the fundamental decline of the dollar. This fundamental shift will be rich in consequences for all asset markets.

2. The Apogee of the Euro – In the Land of the Blind, the One-Eyed is King!

Next to the Supreme Being, there is no subject about which as much palpable nonsense is written as the Euro.

Readers of the US press, some of whom may be severely challenged as regards geography, could be forgiven for imagining a Europe characterized by an enormous Greece to the South, a giant Ireland overshadowing the Western moiety of the continent, with a huge Portugal dragging the entire construction down into the Atlantic trough. A quick look at the map will reassure – Europe is defined by a hypertrophic Germany (striding arm-in-arm with the Northern countries), an aspirational France, and a reluctant, bifurcated Italy... with all the rest just lit'rature!

The Anglo-Saxon media and Kommentariat are replete with warnings of the imminent demise of the Euro. We can only speculate as to whether or not this is due to the fact that, until the Chinese Yuan finally becomes a fully convertible alternative to the US dollar for global trade and reserves (probably 3-5 years from now), the Euro will continue to pose the sole credible challenge to the preponderance of the US dollar.

The reader will note that, tacit all of the warnings of its eminent demise, since the end of the 2008 crisis the Euro has steadily strengthened against the dollar, this despite the very pejorative headline effect of the peripheral European debt-crisis. With the ECB intent upon defending the value of its currency by hiking rates as required, the interest rate differential against the USD is now highly favourable to the Euro (10Y UST 2.2%, vs. 10Y Germany 3.7%), with the largest real money investors (sovereign wealth funds, central banks, Japanese insurers, etc.) continuing to buy Euro assets for diversification, for underlying value, and for the

positive carry (we suspect the last factor to be the preponderant one). Despite the insolvency of several peripheral European states, overall European sovereign debt sustainability is an order of magnitude better than that of either the US or Japan.

The Eurozone sovereign deficit is 4.5% of GDP, i.e. less than half the comparable number for the US (10.9%). We stand by our earlier (low conviction) assumption that, at least in the medium term, there will be no defaults, nor exits from the Eurozone; that said, this is a risky call, since it is a solely political question; there is a non-negligible risk that political considerations in Germany could force a debt restructuring in one or more of the PIIGS². But even so, the essential point is that, while it is conceivable that one or more Eurozone countries will ultimately be jettisoned, and short-term market effects would likely be violent, to lose Greece, Portugal or Ireland would ultimately strengthen the Euro, not weaken it!

like Paolo Coelho's philosophy for the lobotomized...

The Great Recession was the ineluctable result of the deliberate mispricing of capital by central banks and regulatory authorities who collectively came to the realization that the Laws of Gravity could be durably repealed for short-term political gain, and that the true lesson of the Great Depression was that adequately stimulatory monetary policy could bring about the Kingdom of Heaven on earth. Especially in the Anglo-Saxon world, painful fiscal choices could be evaded whilst the gradual impoverishment of the working/middle classes was rendered politically palatable by ever-increasing consumer indebtedness, coupled with steady asset price inflation. This reached a climax between 2004 and the final 2008 implosion, with a veritable orgy of credit creation – a frenzy involving the shadow banking system, the securitization of worthless debt into AAA assets (CDOs) and ultimately, the creation of AAA-rated assets ex-nihilo

In Praise of Dieting PIIGS

There is no joy in heaven like for a sinner repentant, and the fiscal efforts being made by the European periphery are truly impressive. Public wages have been cut, pensions decreased, and inefficient social legislation rewritten. While there have been protests against austerity, the predicted wave of revolution was no more than a figment of the doomsayers' imaginations. The cuts may well prove to have been too late (not too little... just too late), and if Germany wishes to risk a repeat of the "Lehman moment," a couple of the laggards may be forced to restructure. That said, it should be borne in mind that the end result of the crisis shall be a substantial deepening of European fiscal and economic integration. Whether or not this is a good thing we leave to the reader's judgement – personally, we preferred the more diverse Europe of the post-war decades... (But typically, no one asked us!)

3. Cost of Capital – What started in Tranches and Tiers – Shall also End in Tears....

The laws of gravity shall not durably be defied; what is unsustainable shall ultimately not be sustained... and if T&B continues spouting any more simple truths, we shall end up sounding

² *Do not try this at home: on 26 April, T&B picked up a scrap of Greek bonds for client accounts – with the 2014s yielding nearly 24%, even if they are restructured: a) it may be limited to a re-profiling, i.e. a "voluntary" extension of maturities, b) if there is a haircut, we would assume that it would be around the average for the Brady deals – 30%, c) with the bonds trading in the low 60s, and a likelihood of two years continued coupon payment, we find the deal fairly compelling; timing is tricky, it could blow up in one's face, and we would be cautious about catching falling knives.*

(CDS). That the dreadful outcome of all of this came as a surprise to anyone at all simply illustrates the extreme potency of "group-think".

Although T&B's family roots are Austrian³, our economics certainly are not; we do not share the belief of some of our hard-core peers that the devastation of the global financial system – as likely as not followed by a deep depression – was a price worth paying to clear the financial system of the wretched excess of the past decades. We find that the initial set of reflationary measures adopted during the crisis was fully justified by the imperative of forestalling financial Armageddon. That said, the stimulus should have been limited to what was strictly necessary to break the deadly momentum of the crisis, before allowing a

³ *Actually, Bohemian... the old Prague of the Alchemists.*

necessary recession to return the system to of equilibrium; instead, monetary creation has been explicitly aimed at boosting asset prices and economic activity, with the insane notion that this artificial activity would somehow be transformed into “self-sustaining growth”.

Indeed, the counter-argument to our view on QE-1 (but certainly not to QE-2) – an argument deployed by the brilliant Wood and the mercurial Faber – would be that the initial success of reflationary policies inevitably creates a sense of false security and a craving for increasing doses of the same medicine – ergo, QE-2, QE-3, etc.

A political system unable to manage and redistribute pain is doomed – and the hangover from a twenty-year orgy of credit creation and the mispricing of capital can be attenuated, can be spread out over time, but cannot simply be wished away. The attempt to do so is bound to end in tears.

4. Sharpened Chopsticks – The Secular Rise of China

T&B has been going about this theme for the past fifteen years, and it is only now that our views have suddenly become mainstream.... And yet the doomsayers continue to prattle on about the impending Chinese Collapse. Year in, year out – their track record is beginning to approximate that of the FT as regards Russia...

The erstwhile “sole superpower” cannot be expected to take well to the rise of a serious rival, especially one of vastly different ethnicity, ideology and history. Thus, ever since it became obvious that China constituted a meaningful threat to the position of the hegemon – not simply a flash in the pan – there has been much angry prognostication of an impending collapse of the “Chinese bubble”. This is apparently based upon little more than the fundamental assumption that The Creator would never allow such an outrage, nor for His Chosen to be lain low by a bunch of yellow peasants without fashion sense, good manners, much less American-style democracy.

There has been a never-ending series of warnings of the imminent demise⁴ of China:

⁴ *When quoting the likes of Roubini, Bloomberg articles always mention that he was the guy who predicted the 2008 meltdown, or the drop in the dollar, or the War of the*

the banking system was about to blow up, then the collapse in American consumer demand was to be fatal to Chinese growth, then the Bogeyman became the misallocated spending by local governments or the excesses of the Chinese shadow banking system. At the most absurd, we have seen warnings that China would go the way of Japan (indeed, both nations employ chopsticks and pictographic alphabets; other than that they are about as similar as chalk and cheese). Meanwhile, the “moribund” Chinese economy manages to grow by about 10% per annum, and the crash is always just 12 months down the pike.

Twenty years ago, it could be confidently pointed out that 10% growth on almost nothing was still almost nothing. This, of course, stopped being the case around the turn of the millennium, and we are now entering the fundamental breakout phase, a decade or so earlier than even T&B had predicted. Not only is China a global player, but in certain key areas (commodity demand, global GDP growth, automobile market, etc.) it is no longer the second largest. For years, the West has urged China to take on more responsibility on the global stage, and to revalue and widen the scope of use of its currency – both are now occurring – but oddly enough, in a fashion designed to further Chinese national interests rather than to reinforce the hegemony of the West, i.e. – **beware of what you want – you just might get it...**

More relevant to our theme, China is also set upon undermining the primacy of the US dollar. Renminbi savings accounts are now all the rage in Asia, as Dim-Sum bond issues are ripped off of the screens, and Yuan currency swaps are made widely available throughout the emerging world, not just in Asia but also for Eastern Europe, Africa and Latin America.

China will slow down – as living standards reach a certain point >10% annual growth becomes unsustainable, and there will be bumps in the road. But Goldman Sachs predicts that the Chinese economy shall overtake the US by the end of the next decade. It will be a new world, and not necessarily a very friendly one – we may find ourselves

Spanish Succession, or whatever... Why don't they identify those strategists who “predicted the Chinese collapse in 2001... ahh, 2002, no, 2003, actually 2004...” etc. etc.?

growing quite nostalgic for the quiet and predictable era of the primacy of the West.

5. Oil Prices: The Sky is not the Limit! (Jupiter Next?)

Long-time readers will remember that ever since the late 1990s, while the mainstream “experts” were warning that oil prices were unsustainably high (at \$40/bbl!), T&B has tediously intoned that, in fact, crude oil was the ultimate one-way bet – on the way to \$100 and beyond – one of the fundamental bases for our bullish call on Russian financial assets.

While we take some pride in a couple of our prescient calls, which were not entirely obvious when we made them, quite frankly, this is one our Labrador could have managed! What is extraordinary is not that T&B got it right – it is extraordinary that the wider bulge bracket (sell-side commodity analysts, but also the in-house oil company analysts who cautioned against high-cost drilling projects) still have jobs, not just having gotten it so spectacularly wrong, but especially, having persisted with their bad calls long after any sane person would have capitulated.

While Chinese economic growth is the demand-side factor most often cited as the main driver for surging energy prices, in fact, China re-exports much of this oil in the form of everything from plastic toys to motorcars. A substantial share of the increasing Chinese energy-intensity simply reflects the geographic relocation of industrial activity, as a declining West cedes the manufacture of tangible objects to the emerging economies.

None of this was a surprise. What was a surprise was the crisis in the Middle East. While we had long warned that the delicately balanced oil market was exquisitely sensitive to any shocks, the Middle-Eastern crisis has revealed the dangerous fragility of the global energy supply system. Quite fortunately, it stopped just short of Saudi – the place where the doomsday scenario begins.

Peak Oil is drawing nigh, depletion of the world’s super-giant fields is fairly advanced, and, especially, while new oil is being discovered, it is very inconveniently located, with extraction cost mandating an ever-higher break-even price.

A word of caution: at \$125/barrel there is a good bit of financial speculation in the price,

and while, tacit the idiocy intoned in Washington about hedge funds driving up the oil price (they, in fact, consume less energy than a largish pizza parlour), what they in fact do is to greatly contribute to the volatility – if you can’t push it up, push it down! At currently levels, we keep our fingers out of the machinery.

6. What a Lovely Civil War – Libya

Given that the theme of this issue is human idiocy, pride of place in the global category must go to the Libyan imbroglio, which deserves its own special bullet point. To say that Western policy has been “insane” is to understate the case quite dramatically – had they actually wished to drive oil prices to a sustained peak, they would have acted no differently (and, just this once, the US appears to have been slightly less gung-ho than its peers – Sarkozy and Cameron never took the time to try to figure out whom it was that they were arming, nor where the guns might be turned next). Apparently, the world is coming back to 19th-century diplomacy – when the personal whims of Presidents and Kings were the vital determinants for war and peace.

The logic of military intervention in a tribally-based civil war in a major oil producer – in support of a faction the intentions of which one is totally ignorant, and with rules of engagement that essentially guarantee the perpetuation of a stalemate – was never intuitively obvious. The West now fights only “asymmetric wars,” i.e. those where the overwhelming bulk of casualties will be sustained by the locals, and there is no way short of actually occupying the country that they can force the regime change they so desire.

Those who remember the run-up to the Vietnam War will be cognizant of the implications of sending in “military advisors”; the outcome of the South Ossetian war between Russia and a US client-state, Georgia, or the arming of the Taliban in Afghanistan in the late 1970s, illustrates other possible problems with reliance upon proxy armies. Since the Libyan rebels do not stand a hope in hell of dislodging the Libyan army – which has largely remained loyal to Gaddafi – the civil war will most likely drag on for months if not for years, and it seems increasingly likely that Russia will ultimately be called upon to pull

NATO's acorns out of the fire. Russia is most likely in no particular hurry – the sustained increase in oil prices has been a Godsend!

More broadly – blinkered by their puerile ideology – the Western media have engaged in some typically clueless rejoicing as regards the “outbreak of democracy” in the Middle East. Two remarks: first of all, the very real hunger for bread played a role far greater than any imagined “hunger for Democracy” – food prices were the major factor triggering the popular uprising, and nothing has been done to address the fundamental problem of feeding unsustainably growing populations. Secondly, whether or not the Revolution proves to have been beneficial to the Egyptian populace, what should be obvious is that it will be very damaging to the interests of the West. As T&B has warned, the fall of the old guard has created a series of power-vacuums into which the only truly popular and organized force – the radical Islamists – will reliably flow⁵.

Meanwhile, having crushed the popular uprising in Bahrain (with numerous Shia protestors, and the doctors who treated them, disappearing into the hands of the security forces and presumed dead – without a peep of protest from the West), Saudi Arabia does not appear to be seriously threatened for the time being; however the monarchy is obliged to buy social peace by distributing huge dollops of cash to a restive population. Who do you think is ultimately going to pay the bill? (*Hint: the Saudi budget now requires an oil price above \$100...*)

The nightmare scenario is that, with the Americans largely discredited in the eyes of the Gulf monarchs for having abandoned Mubarak as well as their perceived failure to block Iranian advances in the Gulf, the Sunni oil-states could launch a desperate solo attack on Iran. Were this to happen, and the missiles to fly, there would simply be no available source to compensate for the huge loss of oil output – threatening the global economy with a collapse into a new ice age. *Washington, are you listening?*

⁵ T&B was grimly amused to see the Israeli press suddenly start publishing papers about how democracy was not really such a great thing after all, and about who was not quite ready for it yet...

7. And you thought the iPad was “Disruptive”? Check out these Commodities/Metals Prices!

Very much the same logic as for oil applies to commodity prices – metals, foodstuffs, and NFAs. While volatility is likely to be fierce given the financial speculation that amplifies moves in both directions, the trend is clear – and will give rise to one of the most fundamental economic disruptions since the Industrial Revolution. T&B wonders how anyone could still miss the obvious inevitability of our “Neo-Malthusian” analysis, continuing to tell themselves bedtime stories about high-tech fairies solving all the problems of a desperately overstretched planet.

Quite simply we are witnessing the collision of a non-finite growth process with the finite limitations of the substrate – planet earth. Oil and minerals are non-renewable and were created in limited quantities – the only matter for discussion is how long it will take to deplete them (as well as the consequences of liberating the carbon trapped by photosynthesis over the past billion years or so). The cost of replacing diminishing oil reserves is increasing exponentially, whilst “Peak Oil” – the preserve of the lunatic fringe a decade ago – has now gone very much mainstream.

As regards the metals, with increasingly poor ore grades now being mined, and significant geopolitical competition for resources, the cost of commodities is likely to continue its inexorable secular rise, challenging the prevailing economic growth models.

8. The End of the Emerging Markets... and Vive les BRICs!

Breaking news: The “Emerging Markets” are dead, are no longer... the asset class has been disbanded, disaggregated, and consigned to non-existence, by decree of T&B!

The concept of “emerging markets” was initially useful as a designation for poor countries which did not intend to stay that way. It is now almost totally useless, grouping countries as fundamentally different as Korea and Taiwan with the likes of Ecuador and Indonesia. Looking at the globe, we see countries – rich or poor – characterized by sustainable or unsustainable fiscal policies, by positive or negative resource sensitivities, by adequate or inadequate reserves, food supplies, or

domestic political consensus; we do not see “emergings” or “submergings.” Thus, we are amused by all the talk of reallocation from the DM to the EM (and back again). This is the sort of thing that brokers invent when they need to drive business – like switching from Lukoil to Surgut. We doubt that DMs Germany and Japan have broadly similar economic drivers – likewise, grouping oil importers like Thailand with exporters such as Russia makes little sense, whilst an increase in the cost of capital will likely impact current account deficit EMs in much the same fashion as it affects the more improvident of the DM.

On the other hand, somewhat paradoxically, the term “BRICs” is profoundly meaningful. Whatever the differences between the India and Brazil, and despite the overwhelming importance of China within the new global architecture, the BRICs constitute a club of rising economic powers collectively serving notice on the West that the rules of the game have changed, requiring a profound remodelling of the global financial architecture. The US and Europe now account for rather less than 25% of global GDP each, while still maintaining a totally disproportionate influence over the international financial institutions. The first tangible sign of this institutional power shift is the fact that, independently of the BRICs grouping, the G7 has now been consigned to irrelevance, replaced by the wider and more representative G-20. The days of the post-war financial architectures are numbered.

9. Chronicle of a Death Foretold – the US Treasury Market

Another old theme of ours: that the widespread ownership of 10- or even 30-year Treasury bonds by entities having not the slightest intention of holding them to maturity, suggests the workings of the Greater Fool Theory. When official US government sources trumpet the “unparalleled liquidity of the US Treasury market⁶” – it sounds most reassuring... Until, that is, one thinks about what it actually means: we might restate it as “you stand at least a fair chance of getting out of this junk before the market marks it to its real,

⁶ *Much like the (ironically accurate) hailing of the “redistribution of risk” in the CDO bubble... The consequences of which proved not to be quite what the proponents had suggested they would be...*

underlying value!” Brilliant!... Just don’t be the last one to leave.

When Pimco warns that the Treasury market is an accident going somewhere to happen, they are stating the obvious. With the US Fed now the backstop buyer, the market is rigged, and looking for another sucker. If the Fed stops buying up the new supply, China and the other emergings continue to diversify their currency reserves, and issuance continues to increase as budget deficits continue to increase, we would definitely not want to be on the bid...

10. Meanwhile, back in the Intellectually Submerging Markets...

Some of our more primitive critics tend to brand T&B as “left-wing”. In fact, we are no more left/right/or centre than we are Hindu or Zoroastrian – firmly believing that no man whose political/social views can be defined along a simple one-dimensional axis is worth arguing with. The world is a very complex place, and if taken as anything more than guideposts, ideologies – be them free-market, socialist, or theological – are simply an impediment to understanding, a convenient excuse for the refusal to think rationally about complex questions.

The fact that, after the demise of orthodox Marxism, and the Fascist ideologies, persons of otherwise normal intelligence can continue to adhere to the puerile, vapid pontifications of Ayn Rand, or the Tea Party, is a source of no little bewilderment. The deterioration in educational standards, and the “dumbing down” of the popular media, are no doubt a contributory factor here.

When T&B has asserted that, like the sorcerer Circe, ideology turns men into swine, we were usually citing the Palaeolithic right – however it would be foolish to imagine that idiocy is their sole appanage. Two left-learning US economists, Paul Krugman and Joe Stiglitz, have been blithely reassuring the US public that the only way out of the current pickle is to continue printing money while running massive deficits. This is only to be expected from Krugman – a man who won the Noble prize for his contributions to trade theory, but with a precious limited understanding of macroeconomics (yet a powerful political agenda).

Krugman is reportedly so desperate for a job with the Obama administration he would happily write about the wing markings on flying pigs were he to be asked – but to see Joe Stiglitz, the brilliant liberal former World Bank Chief Economist prostituting his science (recently spouting some nonsense about the deficit being primarily attributable to the “output gap”, as if anyone even knew how to measure it!) for political ends is frankly depressing. Yes, Stiglitz is correct in stating that the poor have been abused by a political system rigged to benefit the wealthy, and that some redistribution would be in the interests of justice, but that does not mean that the government can continue to spend money it does not have without the direst consequences.

11. Raising J.M. Keynes

Soren Kierkegaard wrote that “The last Christian died on the Cross” – perhaps, then, the last Keynesian died aged 62 at his farmhouse at Firle, East Sussex, 21 April 1946.

John Maynard Keynes would certainly not recognize anything particularly Keynesian about the “Keynesian stimulus” we are currently enjoying in much of the Anglo-Saxon world. Nowhere in Keynes’ work do we find a suggestion that governments should always and everywhere run deficits. Keynes instead suggested an intuitively logical contracyclical policy – the running of surpluses during the good times, then employing the accumulated surpluses to provide stimulus during the downturns. If any countries in today’s world have applied Keynesian policies, it has been the emerging surplus countries – notably Russia and China – who saved during the boom times, then happily pumped in the stimulus during the downturn, thus maintaining strict fiscal orthodoxy.

Or, indeed, perhaps Keynes never died, instead slipping away to the Kremlin (he was, after all, married to a Russian ballerina...), where FM Kudrin is now channelling for him...

12. The Secular Decline of American Power

I have no personal beef with America. I’ve spent a sizeable chunk of my life in America and much of my family is American... I feel the need to write this as quite a few US economists, even those boasting Nobel prizes, have recently accused analysts who don’t toe the “Washington line” of being “America-haters”.

Such ad hominem tactics are pathetic – the last refuge of intellectual cowards who know they’re losing the argument. For the “Washington line” – inflation isn’t a problem, we don’t need to raise rates and the Fed can print willy-nilly – is not only looking increasingly untenable, but is having a severe negative impact on much of the rest of the world.

Liam Halligan of Prosperity Capital Management, writing in The Sunday Telegraph

*Our American cousins, who quite rightfully feel themselves at liberty to criticize whatever or whomever they choose, are almost comically sensitive to even a hint of criticism as regards themselves – and these days, they are getting rather more than just a hint. We must reiterate a simple truth: **T&B’s personal likes or dislikes are totally irrelevant – it matters only whether our observations and trading conclusions are right or wrong.***

The 1991 collapse of the USSR, as well as China’s wholesale embrace of the capitalist model, marked the apogee of American power, and thus, the onset of its decline. The collapse of the Marxist system created a fundamentally unsustainable situation: a unipolar power structure – never anything more than a metastable transition state. The demise of this unipolar system was hastened by the rapid shift of economic growth away from the developed West towards the developing world and the East, a shift that is gradually depriving the post-war Americano-centric economic montage of its fundamental raison d’être.

T&B has recently been challenged by several of our readers who rather misinterpret our longstanding prediction of the end of the *American Century* to mean some hare-brained suggestion of the imminent collapse of the United States into third-world status. The question, instead, is one of relative positioning, and, especially, of the ability of the American body politic to accommodate the somewhat

traumatic process of secular decline⁷, analogous to that suffered by France and England with the loss of their empires and the waning of European power.

As regards our predictions of a decade ago, we would note serial military defeats (for a would-be imperial power, a stalemate is tantamount to a defeat), an erosion of global prestige seriously limiting the ability of the US to shape the world in its own image without recourse to armed force, an increasingly debilitated middle-class (according to the US Census Bureau, there has been no increase – indeed, a slight decline – in median US family incomes over the past 15 years) with living standards and human development indicators slipping behind those of an increasing number of its Western peers. As elsewhere in the DM, the faith in the expectation of constant progress is on the wane in the United States, coupled with an erosion of the previously unchallenged lead in science and technology.

Similar processes can be seen in other declining powers of the West, but what seems most dire is that the US political process has become uniquely dysfunctional and divorced from reality, with extreme ideological positioning while macroeconomic policy has deteriorated to a degree which would make Hugo Chavez blanche.

While, just a decade ago, for most countries the single vital politico-economic determinant was the all-important relationship with Washington – as every significant international organization had a dominant American presence – at present a truly multi-polar world is coming into being. New regional groupings have been created intentionally excluding the West, while China is becoming the preponderant economic power within previously exclusive US or European spheres of influence, notably South America and Africa.

We are here concerned with politics primarily as it affects economics and, thus, seek to assess the market effects of a shift in the centre of economic gravity away from the West, reversing the historically anomalous situation of the 20th century, when the bulk of global economic production was concentrated

⁷ *Perhaps the sort of outright collapse suffered by the likes of the USSR is more easily assimilated, since it is sharp, undeniable, and compels attention and acknowledgement. It cannot simply be wished away....*

in Western Europe and its offshoots. The inflection point will be the loss of the absolute pre-eminence of the US dollar – probably to be replaced by a multicurrency regime sometime in the second half of this decade. The “Exorbitant Privilege” conferred by the US’ preponderant position in the post-war world – the right to issue the sole reserve currency, and, thus, to run theoretically unlimited current account deficits on credit – was a temptation to which no man should be subjected. This privilege was predictably abused, with the rapid debasement of the US currency by expansionary fiscal and monetary policy likely to provide one last quick fix, but also, to kill the auriferous goose. In fairness, few societies would have resisted the temptation.

In the absence of any realistic hope for global governance given man’s inherent, biological egoism, a multi-polar world is the next-best option and, over the coming decade, a counterweight to the rising powers of the East would be very much to be desired. Thus, we find it distressing that the sole country potentially able to temper the ascendancy of China – the United States – appears to be doing its level best to hasten its own decline.

The American ruling class feeds on raw meat – dominant and imbued with a sense of its own virtue and infallibility, it is unable to comprehend, much less to accept, the growing limitations on American power. This leaves them arrogant and prone to misjudgements, disinclined to seek workable compromises with countries whose fundamental interests may be divergent from their own. If Destiny is not manifest, then game theory becomes a vital field of study.

At worst, the domestic political process has descended into the grotesque, with the likes of Sarah Palin and Donald Trump becoming serious national players, while a Tea Party utterly divorced from reality renders the budget debate an exercise in the theatre of the absurd. The preponderant influence of special interests prevents urgently needed reform, whilst extreme ideological positioning by political parties threatens paralysis.

The situation is rendered more dangerous by the fact that the one area in which American preponderance has not been eroded is military force: a hugely expensive military-industrial complex which has yielded only mediocre real-world results, and which cannot be maintained

indefinitely given the imperative need to reduce fiscal outlays. This could create a dangerous unbalance in policy, with a temptation to monetize military resources, or more dangerous still, a last, desperate attempt to pre-empt the rise of any alternative centres of power perceived to threaten US military supremacy.

Coda – What is Distinctly not Obvious (at least not to T&B...)⁸

The most common question we get from professional asset managers is “what are the warning signs we need to watch for⁹ - What will be the sign that the wheels are starting to come off of that delightful post-crisis reflation trade which has made geniuses of us all?”

Frankly, we haven't much of a clue, and only hope that we shall know it when we see it: Some candidates might include a US yield curve going vertical; the dollar sell-off becoming disorderly; something truly ugly in the commodity markets; inflation numbers which even the Fed cannot ignore; a sudden outbreak of fiscal probity in the US causing severe fiscal drag, or a wave of sovereign defaults. We don't even know whether the trigger will be exogenous (a shock in the Middle East, an outlier event in Beijing, default of a peripheral PIIG, perhaps even an Orange Revolution in Washington) or endogenous, akin to the 2008 Credit Crisis, which simply marked a Minsky Moment when the markets suddenly looked down and hated what they saw...

That said, given that the rally is liquidity-driven and has survived several real-world events which would have been expected to drive investors back into risk-aversion mode, we suspect that the death knell will come from the same source – a withdrawal of monetary/fiscal stimulus causing it to go into reverse. Potential consequences for our favourite asset classes – EMD, currencies, commodities and commodity equities are subject to much debate.

⁸ Those of our readers who believe they have attained any clarity on this one are invited to drop us a line to enlighten – sooner rather than later!

⁹ Analogous to the Japanese reactor engineers whose computer screens started to flash red four seconds before the quake hit, a bit of advanced warning can get one out the door first!

From an asset management standpoint, 2009 was delightfully easy. Our best trading ideas we get from reading T&B, and T&B's ideas were fairly simple – the global reflation trade, the survivability of the Russian economic montage, the secular decline in the dollar (which resumed after a brief, violent interruption during a subprime meltdown which forced Europeans to scramble to find dollars to cover their massive losses in the US mortgage casino), the continued rise of China and the resultant strength in commodity markets. The fundamental market drivers included a continued creation of liquidity ex-nihilo by the central banks, re-leveraging in the financial markets, strong corporate earnings, and a long recovery from a deep sell-off as cash was very gradually redeployed.

T&B had warned that 2010 was likely to be considerably more difficult, and we were delighted that, in the event, it proved to be a somewhat more dilute version of 2009. Emerging market debt spreads continued to compress thanks to a universal hunt for yield, while global equity markets strengthened on the back of monetary stimulus, investor re-leveraging and rising corporate earnings driven by wage deflation from high unemployment. The main growth engine for the global economy – China – never missed a beat, and the China pass-through trades (i.e. most commodities, Indonesian, Thai and miscellaneous Asian emerging markets, even Brazil, Argentina... and Russia) benefitted robustly.

Another couple of years of this would be very welcome – but life just isn't like that, and T&B suspects we have continued in a proud tradition of getting it right too early – and are thus increasingly worried that what we had expected for 2010 may come to pass in 2011; indeed, not only may an unwind be at hand, but also that it may prove fairly traumatic.

Countdown to a Meltdown?

A number of factors conspire to upset the apple cart:

- Withdrawal of liquidity by the central banks

The ECB is already tightening and we expect European rates to hit 1.75 by year-end, and 2.25 within 12 months. Russia is raising rates to finally squeeze entrenched if moderate inflation out of the economy. China, the world's most dynamic economy, is struggling to cool its economy and having exhausted the non-classical measures, is now tightening hard, as are numerous other Asian central banks. Inflation concerns are mounting throughout Asia, with Singapore seeing 5% CPI and house prices that make London look cheap; Taiwan is pressured by runaway industrial growth, and everyone is worried about excessive capital inflows caused by leakage from American QE-2. Concerned with the effect of the tightening cycle on asset prices, we would be shifting our Asian exposure from equities to currencies.

While we continue to assume that the Fed can be expected to continue to provide the addict with further monetary fixes as required, given the consensus view that extreme stimulatory monetary policy is suicidal, they may wait for something truly ugly to hit the markets before QE-3 is finally mooted.

- Fiscal Drag

As we never cease to intone, the elephant in the elevator is the US fiscal deficit¹⁰. It need not concern us here how it is cut (and we would not be surprised to see a whiff of class war in America – resulting in higher taxes for the well-to-do and the corporate sector) nor what the mix of spending cuts and tax hikes will be – but however one cuts it, the impact is going to be deeply recessionary. *As we go to press, the Q1 GDP release shows the economy slowing sharply despite all the fiscal/monetary stimulus Washington and the Fed can throw at it. The reader is invited to draw his own conclusions as to how well it will perform when one or both are cut back.*

¹⁰ *(The Japanese deficit seems even more hopeless – but contra-intuitively, will probably remain quiescent for much of the decade, given the fact that it is denominated in local currency and, a key point, is domestically funded – for another few years, at least...)*

Commodities: Nature's very own Tax Hike

Perhaps one of the most fundamental themes of the 20th century was the increase in disposable incomes in the West as commodities grew ever cheaper, allowing the industrialized countries to capture a growing share of global wealth. For the past decade – essentially the decade during which Chinese growth went from a rounding error to the major growth driver – this trend has reversed... Competition for scarce resources and the hunt for physical assets will constitute the New Normal for the 21st century.

Some may feel reassured in that oil prices are still \$40 below their historic peak – perhaps less reassuring is the fact that shortly after they hit that peak, not only did prices briefly drop back to \$60, but the entire global economy saw the worst deflationary spiral of the past 70 years – the role of oil prices in the Great Recession may be one of those great, underestimated themes. *(Note: as we go to press, we are seeing a violent correction in crude oil prices along with other risk assets – again, this is primarily a function of a reversal of speculative positioning, and does nothing to impeach the our view of the trend.)*

We can think of a single salient factor that could push back the financial unwind into 2012 – the US electoral cycle. For Obama to be re-elected requires that the US avoid slipping back into recession, and most political analysts expect no serious decrease in Federal spending before 2013. Whether or not the economic montage is sustainable for long enough remains an open question.

In brief, we are all back to picking up nickels in front of a steamroller. Our best guess is that, as long as the Fed can keep pouring in stimulus, and the dollar continues to sell off only gradually, the reflation trade stays on. We are becoming worried about Q3 2011, but are very uncertain of the timing, and are currently disinclined to forgo the simple pleasures of the global bull-market in selected risk assets, in particular emerging corporate debt. We would, however, keep a close eye on the seismometer, staying liquid and being ready to jump.

How to Trade It – Jack be Nimble...

*We do not have space for a full portfolio section this month, however the views expressed in previous issues (available from our website) are reiterated, with one major exception – **we have capitulated on gold!***

Currencies

Sell US dollar versus virtually everything – Asian, Latin or European, tangible or intangible; with the entire planet trying to get out of its dollar holdings at the same time, there is little upside in waiting for the last man to exit...

Until last week, the Euro had done rather better than expected as the market had become quite comfortable with the peripheral debt situation. As we go to press, we are seeing a violent correction, and investors expecting the USD to see a near-term consolidation near current levels should consider shorting Euro on the crosses (i.e. short Euro against SEK, SGD, NOK, etc.). Indeed, while in fast markets with a rapid drop in the USD, the Euro benefits from its status as the “un-dollar”; during periods of consolidation, we would expect the other alternatives to catch up. As we go to press, the market is still seeking a level, but once the dust settles, we would reinstate USD shorts against a broad basket of DMs (Euro, SEK, NOK, SGD), commodity currencies (NZD, AUD, RUB) but especially the less volatile emerging currencies (Indonesian rupiah, Thai Baht, Malaysian Ringgit, Korean Won).

The JPY is the widow-maker of the financial markets – the Street is littered with the bodies of those who “got it right too early”, and since we do not even know which way “right” is for the Yen, we would be aggressively flat.

Long Gold Futures: Better Late than Never

Having argued that the “barbarous relic” was antiquated, and that it was far smarter to buy silver or the industrial metals (with silver now up more than 100%, at \$49 we are short Ag via puts) and preferring Asian currencies as a store of value (in AUD terms, gold is essentially flat, although admittedly it has outperformed our other picks, notably the SGD), we are now capitulating and adding gold

futures to our asset allocation. With enough investors worried about debasement of the US dollar, and the Central Banks aggressively joining the party, gold is being squeezed higher... Read Keynes, but don't argue with the market!

Fixed Income: Give me the Easy Trades!

In terms of risk/reward, T&B is still highly favourable to the Emerging Markets Corporate debt space. Yes, spreads have come in quite considerably, but there is still fairly safe money to be made – which in 2011 may prove to be something of a godsend. Beware, however, some of the new deals which are now coming out of the woodwork, in particular in the dodgier frontier markets – it happens at just about this time in every macro-cycle... late-stage bull-market b.s...

We here reiterate our previous calls and allocations. The emerging markets trade is getting a bit long in the tooth, but the carry is delicious! Do your homework as regards default risk, keep margining reasonable to survive the market risk, and, especially, avoid duration risk! Keep portfolios short – duration <4 years.

-Venezuela – PdVSA has been very kind to us – we were optimistic with oil at \$85 – at \$110, we are nearly ecstatic. The short-duration bonds are in our view mispriced, with a compelling carry and surprisingly strong price action. We continue to like Argentina – in particular Provincia de Buenos Aires and the GDP warrants, but we doubt we shall be holding them to maturity, and would be watching developments in Brazil carefully – if Brazil goes into reverse, Argentina follows.

-In the EMEA space, we are further shortening duration, selling down RUSB16 (yield to next call is down below 6% - and they are very likely to be called) and would increase allocation to Renaissance Consumer Finance, KKB subs, and selected Ukrainian assets. On the other hand, we are becoming a bit less sanguine about Kazakhstan's ATF bank – Unicredito is apparently looking to sell, though bidders are probably not thick on the ground.

-Greece. The risk-tolerant, adventurous or frankly suicidal may consider joining us for a nibble of Greek sovereign risk: With the 5 ½% of 2014 trading around 60, there is an awful lot of bad news already priced in... with a chunky 23% YTM if nothing bad does happen. Yes, thank you, we know all the reasons why Greece *has to* restructure... however, a) it may well not do so, largely depending on domestic German political developments (bailing out Greece may well be only the second-worst option for Germany), b) if a restructuring occurs, it could theoretically be limited to a reprofiling, with no loss of NPV, c) in the extreme case, whatever final debt load one believes “sustainable”, we would not expect the haircut in a negotiated restructuring to exceed the average level for the Brady bond deals, i.e. 30%.

Remember – there are no “bad assets” only bad prices for assets!

Commodities

We would be very wary of chasing oil prices further from present levels. Natural gas should continue to recover. Agriculturals are a one-way bet over the longer term, but beware the volatility. Of the industrial metals we would be long only aluminium. NFAs look tempting, especially cotton, but we lack the expertise to trade those narrow markets.

Our long Uranium trade got washed out by a 10m wall of water in Japan. It will ultimately recover, as nuclear power is one vital alternative to increasing use of fossil fuels, however it is too late to sell, and probably too early to buy.

Russian Equities

Our two favourite oils, TNK-BP Prefs and Bashneft Prefs have lost a bit of momentum, but we would continue to hold them for yield. While we continue to like the resource sector, in particular coal and gas (Novatek) we are uncomfortable with the global macros, and as inflation expectations drive monetary tightening around the globe, we would be in no hurry to increase global equity allocations. Global equity markets may well continue to enjoy the reflation trade for a while longer, but it is late in the day, and we would be concerned with the spectre of inflation necessitating a faster pace of rate hikes.

The Eternal Russia

Bill Browder – Yet another Improbable Martyr

Like the *Wedding Guest* in Coleridge’s Rhyme of the Ancient Mariner, Hermitage principal William Browder, now exiled from Russia, the only market in which he had a hope in hell of outperforming, skulks about the back alleys of London, buttonholing the unwary to tell lurid tales of Russian skulduggery. Much like his newfound friend Mikhail Khodorkovsky (whom he so bitterly disparaged, at a time when it was in his economic interests to do so), Browder portrays himself as a martyr for the reform of the system he once so enthusiastically milked – until, that is, the day he fell afoul of its internal rules...

We have discussed this affaire repeatedly, and do not have space to repeat *in extenso* here¹¹ – suffice it to say that Browder is accused by the Russian authorities of a series of financial crimes predating by several years and unrelated to the famous “*stolen offshores*” to which he constantly refers. Mr. Browder, whom to the best of our knowledge has never denied having employed offshore structures to evade the intent of Russian legislation, now claims to have been the innocent victim of political persecution.

There is cause for scepticism here – a man who was never known to do anything at all save as it would flow through to his bottom line, and who in private conversations with this author was as cynical and scornful of both Russia and the Russians as any foreign finance jockey we have met, would now have us believe that he is spending tens of millions of dollars, and essentially all of his energy and professional time in a crusade to recover the \$270m he claims to have been stolen by a few bent cops and bureaucrats for the benefit of the Russian taxpayer. And this **without any possible monetary benefit to himself or his investors**, given that he claims to have

¹¹ *Again, nothing herein should be taken to excuse the tragic death of Magnitsky due to the denial of medical care within the grim Russian prison system. Sergei was played by several parties to this dispute, with his death now used for political gain by some who bear at least a contributory share of the responsibility. We can only hope that those guilty of his unwarranted imprisonment shall be punished.*

emptied out the shell companies before they were purportedly stolen.

Most of the journalists we speak to are privately scornful of Browder for his manipulative handling of the press whom he treats as, at best, useful fools. Alas, given how afraid the media are of his English libel lawyers, they are generally unable to speak their minds. While he has not managed to disrupt the flow of FDI and corporate investment, our friends raising money for hedge funds report that his name comes up repeatedly in discussions with investors – as always, those who choose to believe Western sources on Russian markets end up paying a very high price in terms of lost opportunities.

Whatever he seeks to gain for this anti-Russian campaign, Browder is making the same mistake as those who laid siege to Stalingrad and St. Petersburg, a mistake later repeated by Khodorkovsky: the misguided belief that if you cause the Russians enough pain, they will capitulate. There is simply not enough pain in the universe for that – and Browder shall reap no benefit from the damage he may cause, exiled from Russia and left to trade Middle-Eastern markets where the three-year performance of the Hermitage Global Fund suggests the absence of any competitive advantage.

Any of our readers who seriously believe that his masterful PR campaign – damaging to the Russian investment climate and single-minded to the point of obsession – could be motivated by the selfless desire to benefit the long-suffering Russian taxpayer should contact us without delay – we have a great deal for you on that bridge over the Moskva River... but don't tell anyone else, or they will want it too!

Mikhail Khodorkovsky – Of Gangsters and Tax Raps

Whatever the weaknesses of the judicial process which condemned Khodorkovsky to a long prison sentence (Al Capone, the American gangster, received an unusually harsh sentence for tax evasion – largely due to the FBI's inability to build a watertight case for murder, extortion, and banditry), the man is nevertheless as guilty as Cain – not just of economic crimes so severe as to make a major contribution to the 1998 collapse Yeltsin's Russia, but also of crimes of violence. We are on the record for predicting that further charges

of tax evasion and theft would be brought before the expiration of his first sentence; we now add a prediction that before the end of his second current prison term in 2017, charges will be brought for crimes of blood.

The fact that Menatep was certainly not the sole entity literally stealing Russia and spreading terror in its wake during the 1990s is not exculpatory. Though other players benefitted from (a necessary, if perhaps undeserved) clemency in return for their undertaking to refrain from further large-scale theft and corruption of the political process, this does not mean that this clemency should be held to be a natural right, nor that those who believed that the rules and practices of the disastrous Yeltsin years were still operant, and that the primacy of the Russia State could be challenged, will not be crushed.

What is most striking here is the outright prostitution of the Western press by Yukos/Menatep money and spin doctoring. When the FT is reduced to mouthing the absurd parallels between the saintly Sakharov and the criminal Khodorkovsky, George Orwell must be laughing in his grave. From Hearst to Murdoch – from Pravda to Fox News, the mainstream press is nothing more than a vital appendage to the power-elite.

Khodorkovsky was the best hope for the West to regain control over the domestic political/economic process in the world's largest oil producer. They failed. It is hardly surprising that their tame press reflects this frustration. Can the reader seriously imagine that Khodorkovsky would have received the same fawning treatment had he been an impediment – as opposed to an accessory – to Western political and economic interests?

The Western Kommentariat is as deeply corrupt and as self-serving as the worst of Russian bureaucrats, but unlike the bureaucrat who is refreshingly frank and cynical, the Kommentariat exudes a nauseous air of self-satisfaction and hypocrisy. The famously “free and fair press” has been prostituted by its adulation of those in positions of power, by a substitution of ideology for objectivity, and by cold cash from corporate interests, political pressure groups, and in the case of Russia, corrupt and murderous oligarchs.

(You read it here first!)

The Next President of Russia is...

Whoever the hell Vladimir Putin wishes it to be!

Himself, T&B, Medvedev, his Labrador, someone none of us has ever heard of... Mr. Putin is arguably the man who saved Russia from total collapse at the end of the 1990s, and the great majority of Russians are at least vaguely cognizant of this simple truth. While Russians are deeply cynical about their government – a serious problem in attempting to rebuild a properly functioning state – there is a widespread admiration for VVP, however much this may displease the corrupt and self-referential hacks at the Economist.

To speculate about Mr. Putin's intentions strikes us almost uniquely pointless, given that he is famously disinclined to tip his hand, enjoys watching the rest of us speculate about his intentions, and has been known to surprise... Most speculation thus reflects nothing more than the personal preferences and aversions of the authors. T&B is no exception to this rule, so for what its worth, our personal view:

Putin will come back as President. In any free, fair election, he would trounce Medvedev, though an electoral battle between the two men is most unlikely. One recent rumour suggests that Putin will return as President, with Kudrin as his PM. T&B would be delighted! VVP is a great statesman, but – by his own admission – not cut out to be a great reformer. His contribution to the reestablishment of Russian statehood and stability was historic, but the current soft recovery from the crisis illustrates just how much root-and-branch reform is necessary. He would be the man to provide political cover to those doing the work.

Russian foreign policy needs to go back into adult hands (the recent Libyan imbroglio was pathetic... at the very least, Russia should have negotiated strict limitations on Western involvement in the Libyan Civil War, as well as the need to return to the Security Council for continuing authorization). Putin spoke his mind about the "latter day crusade", only to be sharply contradicted by Medvedev. A few weeks have gone by and it is now obvious that Putin was right, with the Kremlin now belatedly

expressing righteous indignation at an outcome which should have been obvious to all: NATO has become a partisan player embroiled in a civil war, and increasingly alienated from its UN mandate of simply "preventing civilian casualties"... Our heart goes out to Russia's fine Foreign Minister Sergei Lavrov, who is left to try to explain the obvious political missteps of his boss.

Let Them Eat Hay (with a Super-Sized Portion for Mr. Dudley!)

A recurrent theme in the present report is human idiocy; at least for the Russia category, we have a hands-down winner – BP!

All of us make mistakes, but after a true debacle, especially one for which we suffered long, excruciating consequences – most will be disinclined to fall into the same muddy hole twice, in rapid succession... not BP's Dudley!

BP CEO Dudley appears to share with the ornamental goldfish *Carassius auratus* a memory span estimated at some six minutes. BP has had a very interesting time of it in Russia – badly screwed on Chernogor-neft in the late Yeltsin years, they promptly came back for a second helping, joining with the Russian partners AAR (Mssrs. Blavatnik, Fridman and Vekselberg) to set up TNK-BP. Second time lucky! The second deal, negotiated by the genial Lord Browne, quickly turned out to be the best investment in BP's entire history, yielding cashflows nearly equivalent to the purchase price, each year.

Alas, *good enough* was not good enough, and so a few years ago, BP had the very clever idea of becoming not just an oil major but also a gas giant – this by the simple expedient of ridding itself of its Russian partners to make room for a state-run entity, Gazprom. There was a certain logic to this approach, especially if one believes the disinformation retailed by the Economist and the FT about Russia being a unitary, top-down dictatorship – in which case, one had best align one's interests with the dictator! Of course, anyone who actually does business in Russia knows what nonsense this is, but more of that later – we are getting a bit ahead of ourselves...

Seeking to replace their Russian partners, BP organized a “secret meeting” with Alexei Miller in Gazprom’s Moscow offices. As any really competent Russian personal assistant could have foretold, the minutes of the meeting were on Mr. Fridman’s desk by the following morning (Alfa Bank’s security services are widely believed to know what you will do, just a few minutes before you yourself know you are doing it...).

Predictably, AAR was not amused by this clumsy attempt to lift them out of a prime asset, on their own turf – and, when irritated, Mr. Fridman is a formidable adversary. The AAR partners emitted some warning sounds, making it abundantly clear that they had no intention of selling out – to Gazprom or to anyone else – with any further attempts to force their hand definitely not to be appreciated.

When BP persisted, Dudley’s life was made an absolute misery; he was ultimately chased across the border and into a secret location somewhere in the UK – from which he tried for a few miserable months to run the joint-venture in exile, before BP finally realized that the game was up and capitulated. Mr. Putin himself brokered a deal whereby BP handed control to Misha Fridman, in return for preserving their share of the bounteous cashflows.

One would have expected the Anglo-American oil giant to count itself really quite fortunate to have survived almost unscathed, and to sit quietly and enjoy their dividends... but no, not them! In the most recent bout of insanity, Bob Dudley (whose reward for the first TNK-BP debacle was the top spot at BP, after Hayward was forced to resign to placate the Americans) followed in his own footsteps by coming back to Moscow for a second helping – only this time in a mega-deal involving Rosneft, not Gazprom.

BP negotiated a share swap with Rosneft, along with a major arctic exploration deal. The deal was apparently overseen by Kremlin *eminence grise* Igor Sechin, while apparently also receiving the blessings of Sechin’s boss, Vladimir Putin. Unfortunately, what Dudley had intentionally refrained from telling his interlocutors was that the TNK-BP shareholder agreement clearly stated that all of BP’s Russian ventures would be carried out via the

JV – and that any deal with Rosneft was thus null and void.

Once they recovered from their amazement, the AAR partners were livid, suing BP before Swedish arbitration panels and UK courts, all of whom found in their favour. The deal was frozen in its tracks. Dudley found nothing better to do than to pitch more fuel on the fire by claiming publicly that the courts hadn’t found against them (they very certainly had – the case was utterly unambiguous – BP had simply ignored its contractual obligations assuming that the oligarchs would be swept aside by Sechin... *you can’t make this stuff up!*) and that his best offer to the boys was \$22bn, for which they should count themselves lucky, i.e. BP diplomacy at its best.

Predictably, the Russian response to his salvo was unprintable – so there we stand, with a purported counteroffer from the Russian partners valuing the company at a rather optimistic \$60bn, i.e. a \$30bn price tag for their AAR stake... BP must miss the Gulf of Mexico!

The best part of this story is that it subsequently transpired that Mr. Putin himself had warned BP that the widely believed centralization of power in Russia was much overstated, and that it was all a very complex business. You would have thought that – after their experience the first time around (Gazprom is not exactly a minor player on the local pitch) – they would have figured this out by themselves... but never underestimate the power of arrogance!

Can She Dance?

In the middle of the last decade, T&B published “Can She Dance” – asserting that Russia’s magnificent recovery from the crisis, built upon capturing the cash flows from commodity exports coupled with financial/budgetary control was becoming exhausted; the Bear had proved that she could walk – but now, could she dance?

Perhaps we then proceeded to forget our own warnings, which in any event proved typically premature as Russian GDP growth continued to accelerate into the 2008 global crisis. Having missed the full degree of leverage in the financial markets, as well as the very dangerous implications of FM Kudrin’s “Negative Carry Trade” (whereby Russian sovereign assets were banked abroad, while

Russian companies were becoming increasingly dependent upon foreign bank lending) we were unprepared for the full ferocity of the credit crunch. Fortunately, the CBR and Finance Ministry displayed an admirable propensity to learn from past mistakes, and the response to the crisis was rapid, reasonably efficient, and ultimately very successful. While the economy has largely returned to the situation *ex-ante*, reform remains an imperative.

The Medvedev presidency is widely seen as little more than a PR exercise for the benefit of the West, and his record as a reformer is weak at best. We would not be unhappy to see him take up an academic post, and for one of the key Russian reformers to take on the very challenging job of Prime Minister. Vladimir Vladimirovich, makes us happy!

Happy Praying,
T&B

*We remind our readers that they are welcome to forward T&B to any party who might be interested.
We write to be read!*

Comments should be directed to Eric Kraus, on eric@nikitskycapital.com or krausmoscow@yahoo.com

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Like cats and horses, markets – whether emerging or emerged, are apt to do as they damned well choose, and a considerable measure of luck is required to come out in one piece. Exercise caution in all things. Good Luck!

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